5.2 Risks to Municipalities of using TIF

Tax Increment Financing (TIF) is one of the most powerful financing tools available to local governments for encouraging economic development. Using tax revenues to finance certain development costs will encourage growth by providing site improvements that will attract development. That fact is the basis of the "but for" test discussed in section 5.1. TIF is not completely without risks, however. When a local government decides to use TIF, there are still risks that they should be aware of. This section outlines some of the most common risks, and offers advice on how to avoid those pitfalls.

Over-investing

One of the most common ways to use TIF is to fund infrastructure improvements (sewer lines, roads, curbs and gutters, etc.) that make a site more attractive to businesses. By enhancing the site with physical investments, the costs of locating and starting up a new business would be reduced. Municipalities are willing to make these investments because the private development will expand their tax base. When TIF is used, this growth actually pays for the infrastructure investments that encouraged it.

Municipalities can invest significant amounts of money into these infrastructure improvements in hopes that growth will follow (sometimes called the "build it, and they will come" strategy). However, if little or no private development occurs after the improvements are made, there may be no tax increment revenue with which to pay for the investment. If there is no increment revenue, the bonds used to pay for the improvements will have to be paid for with general tax revenue. Paying for these bonds without a larger tax base means a higher tax burden.

Please note: TID project plans may be amended and changed unlimited times throughout the expenditure life of the TID, and the boundaries can be changed up to four times. Planning to use these amendments can help in designing feasible development timetables. More information on amendments is available in section 2.2 of this manual.

Another risk of over-investing can be that the site is improved, but the improvements actually prevent some types of development from being able to use the site. For example, if roads, sewer lines, sidewalks and curbs are installed in a TID, almost any kind of use can be made of the available land (commercial, residential, industrial, etc.). If additional improvements are made, such as a building, potential uses begin to become less likely. If this is the case, the improvements that are meant to attract development can actually serve to prevent it.

This pitfall can be avoided by laying out the planned improvements in stages based on the geography of the TID. Many planners and municipalities design their project plans in "phases," where one area is improved, and development occurs there, before moving to the next. This allows each part of the TID to grow before all the improvements are made and tax dollars are invested. The number and scope of each phase will differ based on the size of the planned development. The development resulting from each phase will generate value increment, resulting in tax dollars that will begin to pay for the improvements. That will leave debt capacity to pay for the next phase, which will bring in another phase of development, and then the next phase can be implemented, and so on. The phased model ensures a steady pace of growth, and prevents too much money from being spent before it is certain that the development will come.

Under-investing

The inverse of the previous risk is not putting enough improvements in place to attract development. If a site is not improved with enough physical improvements, new business may not find it attractive to locate there. Because the purpose of TIF is to finance improvements that will attract new development, this risk is especially dangerous. The “bird in the hand” approach is when municipalities coordinate some investment in the site with some expected private development.

Municipalities are sometimes quite cautious in using their TIF tool, and a coordinated approach is most advisable. Rather than waiting on large growth to ensure payment for the site improvements, coordinating important investment with sizable development will help to make sure that the growth and the investment happens together. A well written project plan and a phased approach to development will work to make a TID a successful development.

Dislocating

Sometimes municipalities will create TIDs to encourage the growth of a new retail or commercial district. These TIDs are sometimes large sections of vacant land near highway intersections, or big lots along a prime thoroughfare. This may be a great way to use TIF, and may help to add significant non-residential tax base in a community. Even communities that already have large retail/commercial sectors can effectively use TIF in this way.

In a municipality that already has a large retail area, however, thought should be given to the way that a new commercial destination will impact those businesses already located in the municipality. A new strip mall along a major highway might be a great way to grow tax revenues and take advantage of a prime location. But if this community has a downtown or main street corridor, the new development could influence the level of business taking place there. If shoppers are drawn to the new development, and spend less in the other commercial areas, the net effect could be negative for the community. Using an economic development tool to grow new tax base should not damage existing businesses in the community.

In addition to the effects within a municipality, some consideration should be given to the impact a new development might have on neighboring communities. The whole idea of TIF is that growth and development should be a partnership, and while individual municipalities create their own TIDs, the surrounding communities may be affected by those decisions. Joint Review Boards will include county, school, technical college and other representatives, so those jurisdictions have say in the use of the TIF tool. But don’t leave the other cities and villages out of the planning.

Over-growing

Municipalities are limited concerning how much property they can have in TIDs at any one time. This restriction is known as the "12% capacity limit". The total equalized value increment in all existing TIDs divided by the total equalized value of the municipality cannot be greater than 12 percent. When a municipality has reached this limit they cannot create any new TIDs and they cannot add property to any existing TIDs. Some describe this situation as being "TIFed out".

One risk related to this limitation is that a well planned TID will fill up with new growth, generating a large value increment. This will result in considerable increment revenue, so many projects or very costly projects would be feasible. The danger with these successful TIDs arises when so much of a community's growth is inside their TIDs that they exceed the limit. The calculation uses the increment value in the numerator, so a fast growing TID in a small community could easily comprise 15 – 20% of the municipality's value after just a few years.

Let's take an example: the Village of Beta is very small and has a total municipal equalized value of $1,000,000. To encourage growth they create their first TID; an industrial TID made up of vacant land. The base value will be pretty small because the land is empty. As soon as the growth begins, that value will start to grow. Growing property values is the point of TIF, after all! Once the increment value of the TID gets above $120,000 the village will be near the limit – almost 12%. In a small community this can happen very quickly, and once the limit is reached no new TIDs can be planned until this one is terminated, or some of it is subtracted out of the TID.

One way to avoid this risk in a municipality without a large equalized value is to plan smaller TID developments. Try to create TIDs that will spawn spin-off development outside the TID. That way property values are growing inside the TID and outside the TID, maintaining a relatively stable TIF capacity limit. Territory subtraction can also be used to remove some land from a TID, and thereby reduce the municipality's TIF usage. Encouraging growth outside of TIDs, using other incentives, is another way to avoid this risk.

Impacts of Growth

The use of TIF to attract development can be a powerful way to expand the tax base. Planning for this growth is important so that the development fits within the overall composition of the municipality. In Wisconsin, communities create "comprehensive plans" to lay out their expectations for their growth. Using TIF can help to achieve these goals, but without careful preparation TIF may actually work against these plans. For example, an area may be designated as a place to have residential growth in the long-term. In the short-term, however, an industrial property owner may want some TIF help to expand near that area. Expanded industrial usage may make sites less attractive for residential development in the long-term. Effects such as these should be anticipated when creating TIDs.

Another impact of growth that needs to be considered is increased demands on services, such as emergency responders, police and fire protection, traffic, trash, water, schools or housing. Development impacts such as these should be planned for in the comprehensive plan. If a large residential development is planned, it must also plan for the increased demands on public schools due to larger numbers of families with children moving into the school district. Jobs are also an important factor to consider. New residents will not be able to move into new residential development if there are not family-supporting jobs in that area. For this reason, the growth that comes with TIF, as well as the growth that happens outside of TIDs, should be planned for and considered as a whole.

Political Risks

In addition to the growth-related risks, there are political risks associated with TIF. The elected officials on the municipal governing body are responsible for creating TIDs, and so the public may hold them accountable for unfavorable outcomes that may arise. This makes the planning stages even more important. The public hearing that is required by TIF Law may be the only required opportunity for public input, but in the face of a controversial proposal, additional hearings may be desirable. These can be held by the Plan Commission, the governing body, or the Joint Review Board. Collecting more public input brings the public into the process and allows those opposed to the proposal a chance to make their case. Ultimately the elected leaders must decide what action to take, but hearing from their constituents may help them make a better decision.

Development Risks

Even the best laid plans can go awry, and when TIF is involved the consequences of these problems can be significant. The success of a TID depends heavily on the growth and private development that goes into a TID. That growth is what generates the increment revenue that pays for infrastructure improvements. When that expected development does not materialize, the municipality will get stuck "holding the bag" and have to pay for the improvements with general purpose tax revenue. This will mean a higher tax burden than necessary.

There are ways to reduce these risks, however. Development agreements can be used to lay out mutual expectations, and set up a way to make sure those expectations are met by both parties. Some development agreements contain "look back" clauses that provide for periodic review of the agreement. This may be helpful to assess actual development generated compared to actual TIF costs spent on a phase-in basis. Other provisions can limit the profit a developer is allowed to make on the subsidized development (with surplus profits going to the municipality) or require certain types of property uses within the TID or provide that the developers pay some project costs if the development doesn't happen as expected. By agreeing to these terms up front, the likelihood of conflict and litigation is decreased.

The TIF Top Ten Questions provide answers to many common questions about TIF, and it includes ten questions for municipal leaders about their readiness to use TIF. Answering these questions during the planning stages of a TID can help to avoid these risks, as well.